

THE DODD-FRANK ACT OVERHAULS THE REGULATION OF PRIVATE FUND MANAGERS AND OTHER MONEY MANAGERS

President Barack Obama, on July 21, 2010, signed into law the most sweeping overhaul of financial services industry regulation since the Great Depression. The Dodd-Frank Wall Street Reform and Consumer Protection Act¹ (the “Dodd-Frank Act”) will, among other things, significantly increase the regulation of money managers, in particular managers of hedge funds, private equity funds, venture capital funds, and other private funds.

The provisions that will likely be of most direct consequence to private fund managers and other money managers will increase regulation of investment advisers under the Investment Advisers Act of 1940 (the “Advisers Act”). Many money managers that have relied on the “private adviser exemption” from registration under Section 203(b)(3) of the Advisers Act will be required to register as investment advisers with the Securities and Exchange Commission (the “SEC”) by July 21, 2011. The Dodd-Frank Act also amends the Advisers Act and other federal securities laws to, among other things, give the SEC explicit authority to define terms under the Advisers Act, revise the “accredited investor” standard of Regulation D under the Securities Act of 1933 (the “Securities Act”), expand the SEC’s anti-fraud authority over conduct occurring outside the United States, and require the SEC to adopt rules to disqualify certain “bad actors” from relying on Regulation D.

A money manager that is an affiliate of a bank or bank holding company will be subject to the Dodd-Frank Act’s provisions implementing the “Volcker Rule,” which generally prohibit such a money manager from engaging in proprietary trading or investing in or sponsoring private funds, subject to certain significant exceptions. The Dodd-Frank Act seeks to address systemic risk concerns not only through the means of the Volcker Rule provisions but also by establishing a new Financial Stability Oversight Council (the “Council”) designed to oversee systemic risk regulation. The Dodd-Frank Act grants the Board of Governors of the Federal Reserve System (the “Federal Reserve”) general systemic risk regulatory authority and the Federal Deposit Insurance Corporation (the “FDIC”) new liquidation authority over systemically relevant financial companies. A money manager or investment fund could be deemed to be a systemically relevant financial company and may be subject to regulation by the Federal Reserve or the FDIC.

Another potentially significant consequence for money managers of the Dodd-Frank Act relates to swap transactions. The Dodd-Frank Act puts into place significant new regulation of over-the-counter (“OTC”) derivatives and persons that engage in transactions in OTC derivatives. The Dodd-Frank Act’s OTC derivatives provisions could require certain entities that are

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf.

counterparties to swaps, such as a private fund that engages in swap transactions, to register with the Commodity Futures Trading Commission (“CFTC”) or the SEC. The provisions also would subject these entities to clearing, margin, and trading requirements when engaging in certain OTC derivatives transactions.

This Memorandum provides an overview of key provisions of the Dodd-Frank Act relating to the regulation of private fund managers and other investment advisers and describes their likely effects on these money managers. Areas discussed include:

- registration and related requirements for private fund managers and other money managers under the Advisers Act;
- other changes to the federal securities laws of significance to money managers;
- Volcker Rule and systemic risk oversight; and
- regulation of OTC derivatives.

Many of the new regulations will take effect on July 21, 2011, and numerous provisions require federal agencies to adopt rules and regulations to implement the requirements of the Dodd-Frank Act by that date. Others are effective upon enactment or, conversely, have relatively lengthy implementation periods. A table setting out effective dates and rulemaking deadlines for the provisions discussed in this Memorandum is provided beginning on page 19.

Negotiations in Congress over the past few months have significantly changed some of the provisions discussed in this Memorandum as compared to earlier versions of the legislation. A money manager would be well served to review carefully the provisions discussed in this Memorandum to assess how they will affect its business. We stand ready to answer your questions, provide additional details, and otherwise assist you in implementing the requirements of the Dodd-Frank Act.

Registration and Related Requirements for Private Fund Managers and Other Money Managers under the Advisers Act

As was true for earlier versions of this legislation, the Dodd-Frank Act markedly increases the regulation of investment advisers, particularly those that manage one or more private funds. The Dodd-Frank Act defines the term “private fund” as a fund that is exempt from the definition of investment company under the Investment Company Act of 1940 (the “1940 Act”) by virtue of Section 3(c)(1) or 3(c)(7) of the 1940 Act. Defined in this manner, the term includes typical hedge funds, venture capital funds, and private equity funds.

Elimination and narrowing of existing exemptions from Advisers Act registration

The Dodd-Frank Act eliminates the “private adviser exemption” under current Section 203(b)(3) of the Advisers Act. That Section previously exempted a natural person or entity that met the Advisers Act’s definition of investment adviser from registration under the Advisers Act if,

among other things, the person or entity advised 14 or fewer clients during the preceding 12-month period. Many money managers currently rely on the private adviser exemption, and its elimination means that those managers will have to register with the SEC unless they can rely on another exemption from registration.

The Dodd-Frank Act narrows another exemption from registration under the Advisers Act so that an investment adviser to a private fund cannot rely on the “intrastate exemption” under Section 203(b)(1) of the Advisers Act. Under this exemption, a person or entity is not required to register under the Advisers Act if the person or entity does not provide advice regarding securities listed on a national exchange and has clients all of which are residents of the state in which the adviser has its principal office and place of business.

New exemptions from registration under the Advisers Act

The Dodd-Frank Act provides five new exemptions from registration with the SEC under the Advisers Act. They are exemptions for:

- an investment adviser to one or more venture capital funds;
- a commodity trading advisor (“CTA”) registered with the CFTC that manages a private fund;
- a “foreign private adviser”;
- an investment adviser to one or more small business investment companies; and
- an investment adviser that manages only one or more private funds and that has aggregate assets under management of less than \$150 million.

The exemptions contained in the Dodd-Frank Act provide specifically as follows:

Adviser to a venture capital fund. The Dodd-Frank Act exempts from registration under the Advisers Act an investment adviser that manages only one or more “venture capital funds.” The Dodd-Frank Act does not define “venture capital fund,” but directs the SEC to issue final rules defining the term by July 21, 2011. The SEC must require an adviser relying on this exemption to maintain records and file reports as the SEC determines is necessary or appropriate.

The scope of this exemption will depend heavily on how the SEC defines the term “venture capital fund.” The SEC staff has not officially discussed how it intends to define the term, but our informal conversations with the SEC staff suggest that the term may be defined narrowly, which could significantly limit the availability of the exemption.

Additional exemption for a commodity trading advisor registered with the CFTC. The Dodd-Frank Act preserves the existing CTA exemption under Section 203(b)(6) of the Advisers Act, which is available to a CTA registered with the CFTC “whose business does not consist primarily of acting as an investment adviser” and that does not advise an investment company registered with the SEC under the 1940 Act or a business development company as defined by

the 1940 Act. The Dodd-Frank Act also creates a new exemption available to a registered CTA that manages at least one private fund, so long as the CTA's business does not "become predominately the provision of securities-related advice" after the enactment of the Dodd-Frank Act.

The Dodd-Frank Act does not define what level of securities-related advice would result in a registered CTA's becoming ineligible for this exemption, and it is not clear whether or how this standard is different from the "primarily acting as an investment adviser" standard in the original CTA exemption. If "predominately" is read to permit a higher level of securities-related advice than the existing "primarily" standard, the new provision would seem to permit a CTA relying on the exemption to engage in more securities-related advice than was permitted under the original exemption. Another somewhat anomalous feature of the new exemption is that it appears to permit a CTA relying on the exemption to advise a 1940 Act-registered investment company or business development company subject to the 1940 Act, so long as the CTA meets the exemption's other requirements.

Foreign private advisers. The Dodd-Frank Act exempts from Advisers Act registration an investment adviser that is a "foreign private adviser." The Dodd-Frank Act generally defines a foreign private adviser as one that:

- has no place of business in the United States;
- has fewer than 15 clients and investors in the United States in private funds advised by the investment adviser;
- has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than \$25 million (subject to increase by the SEC); and
- does not hold itself out generally to the public in the United States as an investment adviser or act as an investment adviser to a 1940 Act-registered investment company or a business development company as defined by the 1940 Act.

This exemption is particularly noteworthy because it requires an adviser to "look through" a private fund it manages and count the U.S. investors in the fund. By its terms, the exemption is very narrow; an investment adviser, for example, that manages a private fund organized outside the United States with \$25 million in investments from one or more U.S. investors would not be able to rely on the exemption. An adviser would not be required to look through to U.S. investors in a fund it manages that is not a "private fund" (*i.e.*, a fund that does not rely on Section 3(c)(1) or 3(c)(7) of the 1940 Act) for purposes of determining whether it can avail itself of this exemption.

Adviser to small business investment companies. An investment adviser to a small business investment company (“SBIC”) licensed under the Small Business Investment Act of 1958 (“SBIA”) can rely on a new statutory exemption from registration as an investment adviser under the Advisers Act. The exemption is available to an investment adviser that advises only one or more SBICs. An SBIC for purposes of this exemption includes: a small business investment company that is a licensee under the SBIA; an entity that has received from the Small Business Administration notice to proceed to qualify for a license as a small business investment company under the SBIA, which notice or license has not been revoked; or an entity with a pending application for a license under the SBIA that is affiliated with one or more licensed small business investment companies.

De minimis exemption. The Dodd-Frank Act directs the SEC to provide an exemption from registration for an investment adviser that manages only one or more private funds and has aggregate assets under management in the United States of less than \$150 million. This “*de minimis* exemption” appears to be unavailable to an investment adviser that provides advice to any client that is not a private fund, even if the adviser has less than \$150 million of assets under management.

Additional reporting and recordkeeping requirements for registered investment advisers to private funds

The Dodd-Frank Act imposes new reporting and recordkeeping requirements on SEC-registered investment advisers to private funds. Such an adviser will need to maintain records and make them available for SEC inspection and file reports for each private fund it manages. The required records and reports must include, for each private fund, a description of:

- side arrangements or side letters, “whereby certain investors in a fund obtain more favorable rights or entitlements than other investors”;
- trading and investment positions;
- the amount of assets under management and use of leverage, including off-balance-sheet leverage;
- counterparty credit risk exposures;
- trading practices;
- valuation policies and practices of the fund;
- the types of assets held; and
- other information that the SEC, in consultation with systemic risk regulators, determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

The SEC is expressly authorized to require an investment adviser to file with the SEC additional reports regarding a private fund it manages “as are necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.” In addition, *all* records of a private fund, not just those required to be maintained, will be subject to SEC examination authority.

The Dodd-Frank Act permits the SEC to modify examination and registration procedures for “mid-sized private funds” to reflect the level of systemic risk posed by these funds. The Dodd-Frank Act does not define “mid-sized private funds,” nor does it expressly require the SEC to define the term.

Family offices

The Dodd-Frank Act directs the SEC to exclude by “rule, regulation, or order” a “family office” from the definition of investment adviser under the Advisers Act. While the Dodd-Frank Act would thus permit the SEC to issue an individual exemptive order upon application by a family office, it is our understanding that the SEC intends to adopt an exemptive rule for family offices and obviate the need for individual exemptive applications. The SEC is subject to more requirements in implementing the exemption for a family office under the Dodd-Frank Act than under earlier versions of the legislation. The Dodd-Frank Act requires that any action taken by the SEC to provide an exemption for a family office under this provision:

- be consistent with the SEC’s previous exemptive policy with respect to family offices;²
- recognize the range of organizational, management and employment structures and arrangements employed by family offices; and
- contain a grandfather provision that includes in the definition of “family office” any person or entity that was not registered or required to be registered as an investment adviser under the Advisers Act on January 1, 2010 solely because the person provided investment advice, and was engaged before January 1, 2010 in providing investment advice, to certain natural persons and entities associated with a family office, including certain registered investment advisers that identified investment opportunities for the family office and invested in those opportunities on substantially the same terms as the family office.

A person or entity that is a “family office” solely as a result of the grandfather provision will be deemed to be an investment adviser for purposes of the anti-fraud provisions of the Advisers Act. A family office that currently relies on the private adviser exemption from registration in current Section 203(b)(3) of the Advisers Act should assess whether it fits within the parameters of the SEC’s prior exemptive policy and thus will be able to rely on an exemption for a family office.

² The SEC has in the past provided exemptive orders to family offices—albeit at an oftentimes glacial pace—taking the position that under certain circumstances, a family office does not fall within the definition of investment adviser under Section 202(a)(11) of the Advisers Act.

Increased threshold for SEC registration

The Dodd-Frank Act modifies the current threshold for registration for an investment adviser with the SEC under Section 203A of the Advisers Act. Under the current threshold, an investment adviser is prohibited from registering with the SEC unless the adviser has \$25 million or more of assets under management. The Dodd-Frank Act in effect raises the minimum threshold for registration with the SEC for a state-regulated investment adviser to \$100 million of assets under management, subject to an exception. An investment adviser with between \$25 million and \$100 million of assets under management that is required to register as an investment adviser in the state in which it maintains its principal office and place of business, is subject to examination as an investment adviser by that state regulator, and does not act as an investment adviser to a 1940-Act registered investment company or business development company as defined in the 1940 Act, may, but is not required to, register with the SEC if the adviser would be required to register with 15 or more states. The SEC may by rule increase the \$25 million and \$100 million thresholds. An investment adviser that is not required to register with and be examined by the state in which it has its principal office will continue to be required to register with the SEC if it exceeds the existing registration threshold under Section 203A of the Advisers Act. The threshold under Section 203A of the Advisers Act applies to all investment advisers. As described above, an investment adviser that manages only one or more private funds may avail itself of an exemption from registration if it has \$150 million or less of assets under management.

The Dodd-Frank Act's limitation on registration by investment advisers with between \$25 million and \$100 million of assets under management could dramatically reduce the number of investment advisers currently registered with the SEC under the Advisers Act. The Dodd-Frank Act does not address whether an investment adviser that is now registered with the SEC by virtue of its having more than \$25 million of assets under management will be required to withdraw its SEC registration if it no longer qualifies for registration with the SEC.

Advisers Act compliance and rulemaking dates

An investment adviser newly subject to registration or subject to new recordkeeping and reporting requirements under the Advisers Act must comply with those requirements by July 21, 2011. By this date, the SEC must define a "venture capital fund" for purposes of the venture capital fund adviser exemption from registration and must issue rules implementing the registration and recordkeeping provisions. To achieve registration before the deadline, advisers likely will have to file their applications significantly in advance of the deadline.

Other Changes to the Federal Securities Laws of Significance to Money Managers

The SEC's rulemaking authority under the Advisers Act

The Dodd-Frank Act, like earlier versions of this legislation, provides the SEC with authority to define terms used in the Advisers Act. The Act limits this otherwise broad authority by

prohibiting the SEC from defining the term “client” to mean an investor in a private fund for purposes of Sections 206(1) and (2) of the Advisers Act, which are anti-fraud provisions applicable to an investment adviser whether or not the adviser is registered with the SEC under the Advisers Act. In drafting this provision, Congress appears to have recognized some of the concerns associated with defining the term “client” to mean an investor in a fund that were expressed by the U.S. Court of Appeals for the District of Columbia in its 2006 decision in *Goldstein v. SEC*.³ The limitation would seem, however, to have less practical value than anticipated by its drafters, as an investment adviser would continue to be subject to the anti-fraud provisions of Rule 206(4)-8 under the Advisers Act, which applies to conduct between an investment adviser and an investor in a fund managed by the adviser. From informal conversations with the SEC staff, we understand that the authority provided by this provision was high on the staff’s wish list for changes to the Advisers Act, and it is likely that the SEC will take advantage of its authority under the provision. The SEC staff has suggested informally, for example, that it may determine to define the term “client” to mean an investor in a private fund for purposes of Section 206(3) of the Advisers Act and Rule 206(3)-2 under the Advisers Act. Read together those provisions require an investment adviser to obtain consent from a client before engaging in a principal transaction or an agency cross transaction with the client. If the SEC were to define client as an investor in a private fund for purposes of these provisions, an investment adviser to a private fund could be required to obtain the consent of each investor in the fund before engaging those transactions with the fund. As a practical matter, this would likely prevent an adviser from engaging in these transactions as compliance would become too costly and time consuming.

Modification of the definitions of “accredited investor” under the Securities Act and “qualified client” under the Advisers Act

The Dodd-Frank Act modifies the definition of “accredited investor” in Regulation D under the Securities Act. Under the literal terms of the Dodd-Frank Act, an individual must upon the Act’s enactment *exclude* her primary residence for purposes of determining whether the individual meets the \$1,000,000 net worth accredited investor standard. Prior to enactment, an individual could include her primary residence in determining whether she was an accredited investor based on net worth. Managers of private funds that are currently engaged, or will be engaged, in Regulation D private offerings should screen prospective individual investors to ensure that they meet the revised standard. A current individual investor in a private fund must meet the revised standard only when making an additional investment in the fund.

The SEC must adjust, four years after enactment of the Dodd-Frank Act, the accredited investor net worth standard for an individual to be “more than \$1,000,000.” The SEC is required to review the entire accredited investor standard as applied to natural persons no earlier than four years after enactment of the Dodd-Frank Act, and then every four years after its first review, and may adjust the standard on the basis of its review. The SEC is also directed to adjust for

³ 451 F.3d 873 (D.C. Cir. 2006).

inflation the “qualified client” standard of Rule 205-3 under the Advisers Act (governing the payment of performance fees to registered investment advisers) within one year after enactment and every five years after the first adjustment.

Expanding the SEC’s anti-fraud authority over conduct outside the United States

The Dodd-Frank Act amends the Securities Act, the Securities Exchange Act of 1934 (the “Exchange Act”), and the Advisers Act to provide U.S. federal courts and the SEC with jurisdiction over violations of the anti-fraud provisions of these laws involving: conduct within the United States that constitutes significant steps in furtherance of a violation, even if the violation is committed outside the United States, and conduct occurring outside the United States that has a foreseeable substantial effect within the United States. This provision confirms the authority of the SEC and other federal agencies to bring suit based on conduct outside the United States, but it does not create an explicit private right of action with respect to such conduct. The provision appears designed to respond, at least in part, to a recent Supreme Court decision that significantly limited the extraterritorial application of the general anti-fraud provision of the Exchange Act.⁴

Disqualification of “bad actors” from reliance on Regulation D

The Dodd-Frank Act directs the SEC to adopt, within one year of the Act’s enactment, rules to disqualify certain persons from relying on Rule 506 of Regulation D under the Securities Act. Rule 506 provides a safe harbor for issuers making private placements under Section 4(2) of the Securities Act. This safe harbor, among other things, allows issuers to make sales to an unlimited number of accredited investors without an offering being deemed “public” simply based on the number of purchasers.

Reliance on Rule 506 has provided issuers with preemption of substantive state securities law requirements for private placement offerings. Issuers disqualified from using Rule 506 would not have the benefit of the safe harbor for determining whether the offering is a private placement under Section 4(2) of the Securities Act, and more importantly would need to comply with securities law requirements of each state in which they offer or sell securities to investors. A disqualified issuer may even be precluded from selling its securities in some states.

The Dodd-Frank Act directs the SEC to adopt disqualification rules that are substantially similar to those in Rule 262 under the Securities Act, which disqualify a person convicted of a felony or misdemeanor in connection with the sale or purchase of a security. The Dodd-Frank Act specifically directs the SEC rulemaking to disqualify a person who is subject to certain types of final orders issued by a state securities commission or other state financial regulator, including orders that:

⁴ A detailed discussion of this Supreme Court case is provided in Willkie Client Memorandum, Supreme Court Issues Landmark Decision on Extraterritorial Application of U.S. Securities Laws (June 28, 2010), available at http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3396/Supreme%20Court%20Issues%20Landmark%20Decision.pdf.

- bar a person from:
 - associating with an entity regulated by a state securities commission or state financial regulator;
 - engaging in the business of securities, insurance, or banking; or
 - engaging in savings association or credit union activities; or
- constitute a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the ten-year period ending on the date of the filing of the offering statement.

The SEC is directed to issue rules to implement this provision by July 21, 2011. It is not clear whether the SEC will adopt rules that apply only to an issuer making an offering under Regulation D or would extend the disqualification of an offering to include past offenses and orders involving officers, directors, owners, or other persons associated with the issuer, or to broker-dealers selling the securities for the issuer.

Volcker Rule Provisions and Systemic Risk Oversight

The often-invoked reason behind Congress's recent efforts toward financial services regulatory reform is increased oversight of systemically relevant financial institutions. For money managers that are affiliates of banks or bank holding companies, among the most important of these provisions are those implementing the Volcker Rule.

Volcker Rule provisions

The Volcker Rule provisions prohibit an insured depository institution (*i.e.*, a bank), a company that controls a bank, a bank holding company, or any of their affiliates (each of which is termed a "banking entity" by the Dodd-Frank Act) from engaging in proprietary trading and from sponsoring or investing in a hedge fund or private equity fund. An asset management firm that is a subsidiary of a bank or bank holding company would be subject, as a banking entity, to these prohibitions. Unlike earlier versions of the Volcker Rule, the Dodd-Frank Act version provides for exceptions to these broad prohibitions. Among the most important of these exceptions for money managers are those for a banking entity sponsoring a hedge fund or private equity fund for its customers and for a non-U.S. banking entity operating outside the United States, as described in greater detail below. The Volcker Rule provisions, in addition to regulating the businesses of banking entities, permit the Federal Reserve to impose capital requirements and quantitative limits on a nonbank financial company supervised by the Federal Reserve.

The Federal Reserve, other banking regulators, the SEC, and the CFTC are directed to issue rules to implement each of these provisions, and the scope and timing of the provisions will depend heavily on the approach taken by these regulators. For that reason, the effects of the Volcker Rule provisions will not be immediately clear. Nonetheless, an asset management firm that falls within the definition of banking entity should assess how the provisions will affect its business and begin to plan for compliance with them.

Prohibition on proprietary trading

The Volcker Rule provisions prohibit a banking entity from engaging in proprietary trading, *i.e.*, “engaging as a principal for the trading account of the banking entity” in any “transaction to purchase or sell, or otherwise acquire or dispose of” any security, derivative, futures contract, an option on these instruments, or any other financial instrument as determined by rule by federal banking regulators, the SEC, or the CFTC. The Dodd-Frank Act defines the term “trading account” to mean an account used for “near-term” transactions. This definition could significantly narrow the scope of the prohibition on proprietary trading, although federal regulators are authorized to modify the definition of “trading account” and could use this authority to expand the scope of the prohibition. The Dodd-Frank Act also limits the prohibition by permitting certain types of trading by a banking entity as discussed below under “Permitted activities.”

Prohibition on investing in or sponsoring a hedge fund or private equity fund

The Volcker Rule provisions prohibit a banking entity from sponsoring or investing in a hedge fund or private equity fund. The term “sponsoring” is defined broadly to include: serving as a general partner, managing member, or trustee of a fund; selecting or controlling a majority of the fund’s directors, trustees, or management; or sharing the same name or a variation of the same name as the fund for corporate, marketing, promotional, or other purposes. The terms “hedge fund” and “private equity fund” are each defined for purposes of the prohibition as an entity that is exempt from the definition of investment company under the 1940 Act in reliance on Section 3(c)(1) or 3(c)(7) of that Act. Under this definition, a hedge fund or private equity fund would include typical hedge funds, private equity funds, and venture capital funds. The Volcker Rule provisions would permit federal banking regulators, by subsequent rulemaking, to include other entities in the definition of hedge fund and private equity fund as the regulators find appropriate. Unlike earlier versions of the prohibition, the Dodd-Frank Act provisions permit a banking entity to sponsor and invest in a hedge fund or private equity fund under certain circumstances, which are described below.

Permitted activities

Despite the prohibitions on proprietary trading and sponsoring or investing in a hedge fund or private equity fund described above, a banking entity is permitted by the Dodd-Frank Act to engage in these activities under certain conditions.

Permitted trading activities. A banking entity subject to the Volcker Rule provisions is permitted to trade for a customer, trade in U.S. government obligations, and trade any security “in connection with underwriting or market-making activities,” so long as those activities “are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.” The Dodd-Frank Act, however, places limits on these types of permitted trading activities. A banking entity may not engage in those types of trading if the activity: creates or leads to a material conflict of interest between the banking entity and its clients, customers or counterparties; directly or indirectly creates a material exposure to high-risk assets or trading

strategies; poses a threat to the safety or soundness of the banking entity; or poses a threat to U.S. financial stability. Federal regulators are directed to define terms including “material conflict of interest,” “material exposure,” “high-risk assets,” and “high-risk trading strategies” for purposes of this provision. A non-U.S. banking entity operating pursuant to Section 4(c)(9) or 4(c)(13) of the Bank Holding Company Act and not directly or indirectly controlled by a U.S. banking entity is generally excluded from the prohibition on proprietary trading, so long as the banking entity’s trading occurs solely outside the United States.

Permitted investments in or sponsoring of a hedge fund or private equity fund. A major change from earlier versions of the Volcker Rule provisions is the inclusion of several exemptions permitting a banking entity to sponsor a hedge fund or private equity fund. These exemptions include, among others, one for a banking entity that sponsors such a fund in which its customers invest and another for a non-U.S. banking entity operating outside the United States, each subject to certain conditions. Under the first exemption, a banking entity may organize and offer a hedge fund or private equity fund if:

- the banking entity provides bona fide trust, fiduciary, or investment advisory services;
- the fund is organized and offered only in connection with the provision of bona fide trust, fiduciary, or investment advisory services and is offered only to persons that are customers of those services of the banking entity;
- the banking entity does not acquire or retain an equity interest, partnership interest, or other ownership interest in a hedge fund or private equity fund except for as follows:
 - the banking entity may make and retain an investment in the fund for the purposes of establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors; or
 - the banking entity must actively seek unaffiliated investors to reduce or dilute the investment of the banking entity so that:
 - within one year after the date of the establishment of the fund, the investment of the banking entity is reduced, through redemption, sale, or dilution, to an amount that is not more than three percent of the total ownership interests in the fund (the banking entity may apply to the Federal Reserve for up to a two-year extension); and
 - the banking entity’s aggregate interest in all hedge funds and private equity funds does not exceed three percent of its Tier 1 capital (generally cash, government securities, or other highly liquid assets) or is immaterial to the banking entity (“immaterial” will be defined by federal regulators);
- the banking entity and its affiliates comply with limitations on transactions with the fund under Section 23A and 23B of the Federal Reserve Act;

- the banking entity does not, directly or indirectly, guarantee the obligations or performance of the fund or of any hedge fund or private equity fund in which the fund invests;
- the banking entity does not share with the fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name;
- no director or employee of the banking entity takes or retains an equity interest, partnership interest, or other ownership interest in the fund unless the person is directly engaged in providing investment advisory or other services to the fund; and
- the banking entity discloses in writing to prospective and actual investors in the fund that any losses in the fund are borne solely by investors in the fund and not by the banking entity and otherwise complies with any additional rules issued by regulators designed to ensure that losses in the fund are borne solely by investors in the fund.

It is important to note that a banking entity would not be subject to these provisions when sponsoring or investing in a pooled investment vehicle that is not a hedge fund or private equity fund as defined by the provisions, such as a collective trust fund that relies on the exemption from the definition of investment company in Section 3(c)(11) of the 1940 Act.

The exemption appears to be crafted to permit asset management affiliates of banks and bank holding companies to continue to manage and provide fiduciary services to hedge funds and private equity funds. But, an asset management firm that wishes to rely on the exemption will likely have to make certain adjustments to its operations. Because the asset management firm itself will be a “banking entity” for purposes of the provisions, any hedge fund or private equity fund it manages will not be permitted to share its name or a variation of its name. The exemption will require the firm to monitor its investments in the hedge funds or private equity funds it manages on an ongoing basis to ensure that it does not exceed the three percent per fund ownership limit or invest more than three percent of its Tier 1 capital in the funds in aggregate. Like other Volcker Rule provisions, this exemption is subject to the rulemaking authority of the Federal Reserve and other banking regulators. An asset management firm that is a “banking entity” would be well served by a close examination of the terms of the exemption and begin to assess the steps it must take to comply with its terms.

A non-U.S. banking entity will have the ability to sponsor a hedge fund or private equity fund beyond that contemplated by the exemption described above. Such a non-U.S. banking entity may sponsor or invest in a hedge fund or private equity fund, so long as no ownership interest in the fund is offered for sale or sold to a resident of the United States and the banking entity is not directly or indirectly controlled by a banking entity that is organized in the United States.

Other limitations under the Volcker Rule provisions

The Volcker Rule provisions may result in regulation of financial institutions other than banking entities. The provisions enable the Federal Reserve to place capital requirements and

quantitative limits on a nonbank financial company (which could include a money manager or a hedge fund or private equity fund) supervised by the Federal Reserve that engages in proprietary trading or invests in or sponsors a hedge fund or private equity fund. The provisions also prohibit a banking entity or any of its affiliates from engaging in certain transactions with a hedge fund or private equity fund for which the company serves directly or indirectly as investment adviser or that the company invests in or sponsors (under the exemption discussed above).

Implementation of the Volcker Rule provisions

Effective date. The Volcker Rule provisions will be effective upon the earlier of 12 months after the issuance of rules that implement the provisions (which must be issued within 15 months after enactment of the Dodd-Frank Act) or two years after the enactment of the Dodd-Frank Act. An institution or company subject to a Volcker Rule provision will have about two years, and perhaps more, after the effective date to bring its operations into compliance with the provision. This compliance period could be extended for up to three additional years at the discretion of federal banking regulators. Assuming that the effective date is two years after enactment of the Dodd-Frank Act, it is possible that a banking entity may not have to comply with Volcker Rule provisions for up to seven years. In addition, a banking entity may apply to the Federal Reserve for an extension of up to an additional five years for compliance with respect to “illiquid funds,” which generally would include most private equity and venture capital funds. If a banking entity were to obtain a five-year extension, it could have up to 12 years to comply with the Volcker Rule provisions for its activities relating to illiquid funds.

Study and rulemaking. The Volcker Rule provisions require the newly created Financial Stability Oversight Council, which is discussed further below, to complete a study and make recommendations on the implementation of the provisions within six months of enactment. Within nine months after the completion of that study, federal banking regulators, the SEC, and the CFTC must consider the findings of the study and adopt rules to carry out these provisions. Final rules, then, must be issued within 15 months of enactment, or by October 21, 2011. The federal banking agencies, the Federal Reserve, the CFTC, and the SEC must consult and coordinate with each other, as appropriate, to ensure that, to the extent possible, the regulations issued under these provisions are comparable and provide for consistent application of the provisions. The Financial Stability Oversight Council is responsible for coordinating the regulations issued under these provisions.

Federal regulators are provided authority under the Volcker Rule provisions to issue rules that relate to internal controls and recordkeeping to ensure compliance with the provisions. Under this authority, a federal regulator may order the termination of an activity or disposal of an investment when the regulator has “reasonable cause to believe” that a banking entity or nonbank financial company that is subject to the provisions has made “an investment or engaged in activity in a manner that functions as an evasion of the requirements” of the provisions.

Systemic risk oversight

The Dodd-Frank Act creates a Financial Stability Oversight Council that may designate a nonbank financial company as subject to supervision by the Federal Reserve if, among other things, the Council “determines that material financial distress” at the nonbank financial company “could pose a threat to the financial stability of the United States.” A “nonbank financial company” as defined in the Dodd-Frank Act could include an investment adviser or a hedge fund, private equity fund, mutual fund, or other investment fund. The Federal Reserve will also have general systemic risk oversight responsibilities for “large, interconnected” bank holding companies that have \$50 billion or more in assets. The Act provides the Federal Reserve with authority to impose various requirements on nonbank financial companies and bank holding companies that are subject to the new systemic risk oversight. These requirements may include new capital, leverage, liquidity, concentration, general risk management, and reporting requirements.

The Dodd-Frank Act provides the FDIC and the Federal Reserve with authority to determine that a systemically relevant financial company is failing and should be liquidated by the FDIC. That determination would be made on the basis of criteria relating to the financial health of, and systemic risk posed by, the company. An SEC vote would be required to place a broker-dealer registered with the SEC into involuntary liquidation.

Regulation of Over-the-Counter Derivatives

Some of the most wide-reaching changes to the regulation of U.S. financial markets may come from the Dodd-Frank Act’s provisions that increase regulation of OTC derivatives that fall within the Act’s definitions of “swap” and “security-based swap.” The Act contains extensive new requirements relating to these instruments, including significant new requirements for market participants, such as private funds, engaging in transactions involving the instruments. The discussion of these provisions in this Memorandum that follows below is intended to provide a broad overview of key aspects of the new regulations and does not address all of the requirements that will be applicable to swaps or security-based swaps or persons that engage in transactions in these instruments. For a more detailed discussion, please see our client memorandum titled “The Wall Street Transparency and Accountability Act: Implications for Derivatives Markets Participants.”

Regulation of “swaps” by the CFTC and “security-based swaps” by the SEC

The Dodd-Frank Act will result in regulation of a wide range of instruments that until now have been unregulated for most practical purposes. The Dodd-Frank Act generally gives jurisdiction over “swaps” and persons engaging in swap transactions to the CFTC and provides jurisdiction to the SEC over “security-based swaps” and persons engaging in transactions in security-based swaps. The CFTC and SEC will share jurisdiction over instruments, and activities related to instruments, that have characteristics of both swaps and security-based swaps.

Swaps and security-based swaps are expected to be subject to largely the same types of substantive regulation under the Dodd-Frank Act. The majority of both types of swaps will, among other things, be subject to clearing requirements imposed by the CFTC or SEC, as appropriate. In general, swaps and security-based swaps will be required to be cleared by a registered clearing house. Swaps subject to the clearing requirements will be required to be traded on a board of trade, on a securities exchange, or through a swap execution facility. The Act also provides the CFTC and SEC with broad anti-fraud authority over swaps and security-based swaps.

Definition of “swap” and “security-based swap”

The scope of the provisions regulating OTC derivatives is, in large part, determined by the Dodd-Frank Act’s definitions of “swap” and “security-based swap.” The Act defines the term “swap” broadly to include more than those instruments traditionally viewed as swaps. “Swap” for purposes of the Act thus generally includes:

- options, such as puts, calls, caps, and floors on most reference assets;
- swaps, such as those on interest rates, broad-based securities indices, and most other reference assets;
- credit default swaps;
- any other instrument “that is or becomes commonly known as a swap”;
- foreign exchange swap transactions and foreign exchange forward contracts (unless excluded from the definition by determination of the Secretary of Treasury); and
- an instrument that combines any of the above.

The definition of swap generally *excludes* futures contracts and forward contracts that are likely to be settled by physical delivery. A “security-based swap” is also excluded from the definition of swap; that term is instead defined as a swap based on a single security or a narrow-based security index.

Given the uncertainty about the text of the law and its interpretation and enforcement by regulators, the full effect of the Dodd-Frank Act’s OTC derivatives provisions will take time to assess and will in large part depend upon the results of the required administrative rulemaking process. Any OTC instrument that provides for future or contingent payment and is settled on a cash basis should be examined on a case-by-case basis to determine whether the instrument would be considered a swap for purposes of the Dodd-Frank Act.

CFTC regulation of “swap dealers” and “major swap participants” and SEC regulation of “security-based swap dealers” and “major security-based swap participants”

The Dodd-Frank Act, in addition to regulating swaps and security-based swaps, subjects persons or entities that fall within the definition of “major swap participant” or “swap dealer” to new regulation by the CFTC and persons or entities that fall within the definition of “major security-based swap participant” or “security-based swap dealer” to new regulation by the SEC. In particular, the Dodd-Frank Act requires these persons or entities to register with the CFTC or SEC, as appropriate. Those persons or entities also will be subject to recordkeeping and reporting requirements, margin and capital requirements, and business conduct guidelines that will be established by the two regulators. It is unlikely that the manager of a private fund or other pooled investment vehicle would fit the definition of major swap participant or major security-based swap participant or the definition of swap dealer or security-based swap dealer by virtue of the manager’s advising the investment vehicle about engaging in swap transactions. Such a manager, however, should assess whether a private fund or investment vehicle it manages meets the definition of major swap participant or major security-based swap participant.

A major swap participant or major security-based swap participant that is an affiliate of a bank may be subject to provisions in the Dodd-Frank Act that have been termed the “push-out rule.” The push-out rule provisions are similar in principle to the Volcker Rule provisions prohibiting proprietary trading, but instead address the use of swaps by certain banks and their affiliates. Though the primary focus of the push-out rule provisions appear to be institutions that access the Federal Reserve discount window or a Federal Reserve credit facility, the provisions also apply to asset management affiliates of banks that are major swap participants or major security-based swap participants. The push-out rule provisions could require a swap participant to restrict its activities in order for its bank affiliate to be able to access the Federal Reserve discount window and credit facilities. These restrictions include complying with the limitations on transactions set out in Sections 23A and 23B of the Federal Reserve Act and other restrictions imposed by federal regulators.

Definitions of “major swap participant” and “major security-based swap participant”

The Dodd-Frank Act’s definitions of “major swap participant” and “major security-based swap participant” appear designed to include a person or an entity that holds positions in swaps, such as, for example, a commodity pool, as opposed to a person that advises about trading in swaps or holding swap positions, such as a CTA. A “major swap participant” is defined specifically to include a person or entity:

- that maintains a substantial position in swaps for any major swap category as determined by the CFTC;
- whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or

- that is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by federal banking regulators and maintains a substantial position in outstanding swaps for any major swap category as determined by the CFTC.

The Dodd-Frank Act requires the CFTC to issue rules to define the term “substantial position” for purposes of this definition. Two types of swap positions are to be excluded when determining whether a person or entity maintains a “substantial position”: positions held for hedging or mitigating commercial risk (which may be defined by the CFTC) and positions maintained by certain retirement plans held for purposes of hedging or mitigating risk directly associated with the plans.

“Major security-based swap participant” is defined as a person that meets the above criteria with respect to security-based swaps. The SEC is subject to analogous requirements in defining terms and designating security-based swap categories for purposes of the definition of major security-based swap participant as is the CFTC with respect to the definition of major swap participant.

Definitions of “swap dealer” and “security-based swap dealer”

The Dodd-Frank Act defines the term “swap dealer” to mean a person or entity that holds itself out as a dealer in swaps; makes a market in a swap; regularly enters into swaps with counterparties for its own account in the ordinary course of business; or engages in any activity that causes the person or entity to be commonly known as a swap dealer. The definition of swap dealer excludes a depository institution when the institution enters into a swap with a customer in connection with originating a loan for that customer. A “security-based swap dealer” is generally defined as a person or entity that meets the definition of a “swap dealer” with respect to security-based swaps. The Act directs the CFTC and the SEC, respectively, to provide exemptions for a swap dealer or a security-based swap dealer that engages in a *de minimis* amount of swap dealing with or on behalf of its customers.

Effective date of OTC derivatives provisions

The Dodd-Frank Act’s OTC derivatives provisions generally become effective one year after enactment of the Act or, if a provision requires rulemaking, 60 days after publication of the final rule. Swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants will each be required to register with the CFTC or SEC, as appropriate, by July 21, 2011. The CFTC and SEC must also publish rules setting out registration, minimum capital, and margin requirements by July 21, 2011. Swap clearing requirements for some swaps may become effective as early as October 21, 2010, and the various reporting requirements related to swaps will be phased in over the course of the next six months.

Summary of Key Dates

Many provisions of the Dodd-Frank Act take effect on July 21, 2011 and require the SEC or other federal regulators to adopt rules and regulations to implement the Act's requirements by that date. The following charts set out the compliance dates for the provisions and rulemakings described in this Memorandum.

Compliance dates

Compliance By	Provision
July 21, 2011	Amendments to the Advisers Act generally take effect. Investment advisers newly subject to registration with the SEC under the Advisers Act must register by this date.
July 21, 2010 (upon enactment)	The accredited investor net worth standard for an individual investor <i>excludes</i> the individual's primary residence.
July 21, 2011	U.S. federal courts and the SEC are provided with expanded extraterritorial jurisdiction over violations of anti-fraud provisions in the Securities Act, the Exchange Act, and the Advisers Act.
<p>The earlier of July 21, 2014 or two years after issuance of final rules for the provision.</p> <p>Compliance dates may be extended by up to three one-year periods and up to one five-year period for illiquid funds.</p>	Volcker Rule provisions on prohibited activities and divestiture requirements become effective.
July 16, 2011 or 60 days after publication of a final rule.	OTC derivative provisions generally become effective, including the required registration of certain swap dealers and major swap participants with the CFTC or SEC.

Compliance By	Provision
As early as October 21, 2010	Clearing requirements for certain swaps.
As early as January 17, 2011	Reporting requirements for certain swaps.

Rulemaking dates

Rulemaking No Later Than	Subject of Rulemaking
July 21, 2011	SEC implements new reporting and recordkeeping requirements for advisers to private funds that must register under the Advisers Act.
July 21, 2011	SEC defines “venture capital fund” for purposes of the exemption from registration as an investment adviser under the Advisers Act.
July 21, 2011	SEC inflation-adjusts the “qualified client” standard of Rule 205-3 under the Advisers Act.
July 21, 2014	SEC adjusts “accredited investor” under Regulation D’s net worth standard to be more than \$1,000,000. The SEC also reviews the entire “accredited investor” standard applicable to individuals and adjusts the standard based upon this review.
July 21, 2011	SEC disqualifies certain felons and other “bad actors” from relying on Regulation D.
October 21, 2011	Federal banking regulators, the SEC, and the CFTC must issue joint rules to define terms used in the Volcker Rule provisions and limitations to reflect the recommendations of the Financial Stability Oversight Council.

Rulemaking No Later Than	Subject of Rulemaking
July 16, 2011	SEC and CFTC generally implement OTC derivatives regulations. This includes publishing rules that establish registration, swap clearing, and minimum capital and margin requirements.

* * * * *

If you have any questions concerning the matters described in this Memorandum, please contact Barry Barbash (202-303-1201, bbarbash@willkie.com); Rita M. Molesworth (212-728-8727, rmolesworth@willkie.com); Roger D. Blanc (212-728-8206, rblanc@willkie.com); Daniel Schloendorn (212-728-8265, dschloendorn@willkie.com); Martin R. Miller (212-728-8690, mmiller@willkie.com); Jai Massari (202-303-1133, jmassari@willkie.com); or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, D.C. 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, D.C. telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

July 23, 2010

Copyright © 2010 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York's Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.